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On Drivers of Asset Pricing Factors

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2019

document version

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citation for published version (APA)

Vidojevic, M. (2019). *On Drivers of Asset Pricing Factors*. [PhD-Thesis - Research and graduation internal, Vrije Universiteit Amsterdam].

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Abstract

The core purpose of a well-developed financial system is to allocate resources toward their productive use. Given the sheer size of financial markets, no one can dispute their importance in the global economy. Financial economists have studied how markets function for decades. A prominent finance theory, proposed in the 1960s, known as the Efficient Markets Hypothesis (EFM) has strongly influenced this area of research since then. It states that financial markets accurately process all available information about an asset, or in other words, that the price of any given asset that we observe is the “correct” price. All agents that participate in the market are rational, meaning that they possess a full understanding and knowledge of how the prices are determined. This simplifies things greatly for investors, as it implies that the market does not give anything away for free. The only way to have higher returns on invested capital is to take on more risk.

However, the EFM has been greatly contested and alternative theories in which the markets are not fully efficient have been proposed. This debate to date remains unsettled. This dissertation consists of four chapters that aim to improve our understanding of this area.

Chapter 2 shows that we still do not have a conclusive explanation for one of the first empirical findings that challenged the notion of market efficiency, namely, the fact that more risk does not necessarily lead to higher returns in the stock market. Chapter 3 provides novel evidence that agents act in irrational ways and slowly react to new information in the market thus causing errors in pricing called the “idiosyncratic momentum anomaly”. Chapter 4 shows that certain macroeconomic indicators, such as inflation and bond yield spreads, influence prices of stable, low-risk stocks. Chapter 5 challenges one of the main assumptions of the EFM that economic agents always act in a rational way. We show that market participants are in fact vastly different in the way they process information and that this can lead to significant deviations between the prices observed in the market and the “correct” prices.

The last decade has seen a rise of an investment paradigm that directly leverages on the findings of the empirical asset pricing literature commonly referred to as factor investing. Today, more than \$1 trillion is invested in factor-based strategies globally and the findings of this dissertation have important practical implications for their design and implementation.